Putting Tenant Improvement Allowances to work for Tenants”¦ and Landlords

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While landlords often see tenant improvement allowances (TIA) as a good way to seal a deal or keep a desired tenant, focusing solely on the amount misses some of the intricacies of the incentive.

What comes after the dollar sign is just one thing to consider. In fact, a poorly drafted TIA could work against a landlord’s interest.

Here are some questions landlords can ask when drafting a TIA that meets the goals of all parties.

What costs and expenses should be included in the TIA?

Should the allowance just be for hard costs (labor and construction) or a combination of hard costs and soft costs (furniture, fixtures, equipment and designing, architectural and engineering fees)?

Or, the tenant may want to receive monthly disbursements of the TIA depending on the size and nature of the improvements to be made while the landlord may only want to make a single disbursement of the TIA upon full completion of the work.

A middle ground could be to make percentage disbursements of the TIA upon percentage completion of the improvements, i.e., 30/30/30/10.

How should payment be structured?

In all payment scenarios, the landlord should condition payment of the TIA on the following:

- Receipt of lien waivers from all parties providing work or supplying materials.
- Confirmation the work has been inspected and approved by the landlord or landlord’s representative to verify all such work has been completed in accordance with approved plans and specifications.
- Receipt of all necessary permits and approvals for all work completed.
- Confirmation the tenant is not in default under the lease.
- Receipt of a certificate of occupancy (temporary or permanent as applicable) with proof of satisfactory inspections and approvals by all required governmental entities.
- Final payment whether paying the TIA in increments or a single payment, the tenant is open for business at the premises and has commenced paying required rent.

There may be other conditions justified by the particular nature or extent of the work to be completed or the nature of the tenant’s business which may also need to be conditions to making any payments.

Should landlords ask for warranties, timelines and budgets?

Landlords should consider getting warranties of construction, obtaining and approving a budget for the work to be completed, requiring the tenant to pay all costs above the TIA and establishing a deadline for completion of the work.

The landlord also should address in the lease the items to which the TIA applies that may be removed from the property by the tenant at the end of the lease.

And there may be trademarked items the tenant requires to be removed and which the landlord may want the tenant to remove, and that can be stipulated.

How is the TIA taxed and can the tenant avoid paying taxes on the TIA?

The terms of the TIA will also impact how the TIA is treated for income tax purposes and whether the TIA qualifies for the safe harbor for qualified lessee construction allowances provided in the Internal Revenue Code.

The safe harbor allows a tenant to exclude the TIA from income if the TIA is received under a short term lease (i.e., 15 years or less, including renewal options), the TIA is used for constructing or improving qualified long term real property (non-residential real property) for use in the tenant’s retail trade or business at the leased premises, the TIA is expended within eight and a half months of the end of the

year in which received, and the improvements must revert to the landlord upon termination of the lease.

The lease agreement should specifically reference the safe harbor. The following is an example of a safe harbor provision:

> The Tenant Improvement Allowance provided by this section is, among other things, for the purpose of constructing or improving qualified long-term real property for use in the Tenant's trade or business on the Premises and the Tenant Improvement Allowance shall be treated by Landlord and Tenant as a qualified lessee construction allowance within the meaning of Section 110(a) of the Internal Revenue Code of 1996, as amended, and the regulations, promulgated thereunder, to the extent the Tenant Improvement Allowance is actually expended for constructing or improving qualified long-term real property as determined by the Tenant and otherwise meets the applicable requirements. The parties hereto agree to report the Tenant Improvement Allowance accordingly in a consistent manner for federal income tax reporting purposes.

If the TIA qualifies under the safe harbor, the landlord is treated as the owner of the improvements and would depreciate the improvements over a 39-year period with certain improvements potentially eligible for depreciation over a shorter period.

If the safe harbor does not apply, the tenant could be required to recognize the entire amount of the TIA as taxable income when received and the landlord would be required to amortize the TIA over the term of the lease as an expense incurred in securing the tenant. This result may or may not be more favorable for the landlord depending upon the improvements constructed or assets purchased with the TIA.

How the TIA is structured and the resulting income tax treatment should be addressed by the landlord with the landlord's tax advisor to ensure the provisions of the lease regarding the payment of the TIA are drafted in a manner most beneficial to the landlord's interests.

Best for all

When a landlord follows this set of questions. a well-crafted TIA will lead to a great outcome for landlord and tenant. The landlord is protected with transparency and a good agreement, and the tenant has a plan to follow that is clear and concise with a financial plan that will lead to a successful build-out.

Should you have any questions, please reach out to Grant Dobson or another member of our Real Estate practice group.